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Policy Notes

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Sustainable Rural Finance:
*Policy and design issues**

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Like in several developing economies in the Asian region, new technologies and the green revolution were also introduced in Philippine rural areas in the last decade. This raised agricultural productivity and rural incomes and triggered major investments in irrigation, farm-to-market roads, and input supply distribution. However, for a number of reasons, Philippine agriculture has failed to sustain its short-lived growth and remained a stagnant sector. In this light, a program to modernize the agriculture and fishery sector was launched through the passage of the Agriculture and Fisheries Modernization Act (AFMA) in December 1997. To increase agricultural productivity, the AFMA was to introduce modern technologies and provide accessible inputs and support services such as basic infrastructure, credit, and information and marketing support. An important provision in this law was the creation of an Agricultural Modernization Credit and Financing Program (AMCFP) that intends to provide sustainable financing to the sector.

The Medium-Term Philippine Development Plan (MTPDP) for 2001-2004 recognizes the importance of an efficient rural finance market and thus identifies relevant policies and strategies to attain this objective. The key emphasis is on sustainable financing of rural development that is anchored on market-based principles and more effective rural financial institutions. The specific strategies for rural finance are:

- Increase of access of small farmers, fisherfolk, upland dwellers and indigenous peoples to credit, including long-term financing;
- Promotion of a savings-led approach to agricultural and micro-financing to encourage capital formation

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among farmers, fisherfolk, upland dwellers and indigenous peoples, household microenterprises, and rural banks; and

✼ "Anchoring" of the Agro-Industry Modernization Credit and Financing Program (AMCFP), as provided under RA 8435, on market-based mechanisms and pursuit of the phase out and consolidation of all directed credit programs as programmed by the Agricultural Credit Policy Council and the National Credit Council.

The rural finance policies and strategies under the MTPDP and AFMA are undoubtedly a radical departure from the subsidized, directed credit programs that government has implemented in the past decades. Philippine policymakers in the 1970s, 1980s and even the 1990s, at times supported or even encouraged by external donors, had intervened in the rural credit markets to direct credit to target sectors at highly subsidized rates of interest.[1]

This *Policy Notes* discusses the current policy framework for rural finance in the light of past experience and the emerging innovations in the microfinance market. After this brief introduction, the next section presents some trends in access to rural credit. The section on current rural finance policy framework then follows after a short critique of past rural credit policies pursued by the government. The final section analyzes policy and design issues for sustainable Philippine rural finance.

Trends in agricultural and rural financing[2]

Various surveys conducted by the Technical Board for Agricultural Credit,[3] the Agricultural Credit Policy Council (ACPC) and Social Weather Stations (SWS) since 1985 show that, on the average, only 38 percent of farm households borrow.

Informal and formal sources

Table 1 shows that about one-third (29 percent) of this percentage of borrowing farm households borrow from formal sources of credit while the rest have persistently depended on informal sources of credit. The proportion of households in the rural areas borrowing from informal sources such as big farmers, moneylenders, traders, input suppliers, friends and relatives has remained the same over the years.

Table 1. Incidence and source of borrowing (in percent)

Period	Incidence of Borrowing	Formal	Informal
1985-85	32	32	65
1986-87	37	28	66
1988-89	44	20	82
1991-92	35	26	85
1992-93	36	32	68
1994-95	33	31	69
1996-97	40	33	67
1997-98	47	24	76
Average	38	29	72

On the other hand, while rural banks lend to small farmers and microenterprises, commercial banks finance large-scale agriculture. Some private thrift banks cater to small and medium enterprises located in the countryside. Government financial institutions such as the Land Bank of the Philippines lend to private rural financial institutions, e.g., rural banks and cooperatives, on a wholesale basis. The latter in turn provide retail loans to small farmers and other small-scale economic agents in the credit market.

Without government funds, it seems that private banks would not cater to small-scale borrowers. For instance, while total loans granted by formal financial institutions to the agriculture sector have nominally been increasing since 1980, the ratio of agricultural loans to total loans granted by the banking sector has drastically

[1]*Purita Neri and Gilberto M. Llanto. 1985. Agricultural credit subsidy.* Central Bank Review.

[2]*This section draws on previous papers by Gilberto M. Llanto and Ma. Piedad Geron.*

[3]*This office was replaced by the Agricultural Credit Policy Council in late 1986.*

declined from 1980 to 1998—from 22 percent in 1981 to 8 percent in 1983 and further down to less than 1 percent in the late 1990s, signaling a declining amount of financial resources going to the agriculture sector.

The decline in financing for agriculture and the countryside was most evident among commercial banks, with their proportion of loans declining from 6.6 percent in 1986 to only 0.4 percent in 1998. On the part of rural banks—the major source of loans, volume-wise, for those in the rural areas that have access to bank lending—the proportion of agricultural loans granted has likewise been on a downtrend.

Meanwhile, the Land Bank of the Philippines, the government bank mandated to serve agrarian reform beneficiaries, has increased the share of agricultural loans in its total loan portfolio from 7 percent in 1987 to about 30 percent in the late 1990s, in contrast to the trend of the private bank loan portfolios. This share, however, is

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still very small considering that the LandBank was geared to be the government's financing arm for countryside development in the first place. Notwithstanding the supply-led financing strategy adopted by the government, therefore, private banks have chosen to ignore the rural sector and seem to be more comfortable financing the urban sector and its various trading and commercial activities.

A closer look, though, at these bank financing data for countryside development reveals a noticeable trend—the shift of banks' loan portfolio from agricultural production, i.e., basically rice and corn production, to rural-based enterprises. Nonfarm activities, especially those implemented by small and microenterprises, are getting a fair amount of bank financing for the rural sector. It is unfortunate that data on loans granted by banks to nonfarm enterprises could not be segregated from the usual loan data reported by banks since these are usually lumped with commercial and industrial loans of banks. But it is possible that the reported bank financing for countryside development is somewhat understated although the relative magnitude of nonfarm enterprise financing is difficult to establish.

Other sources of financing

Aside from banks and informal sources of credit, government nonfinancial agencies have also provided credit to the small borrowers in the agriculture sector. Through directed credit programs (DCPs), the government attempted to direct the flow of credit resources to targeted sectors for specific purposes.[4]

A recent survey conducted by Llanto and others reported that 86 directed credit programs were implemented by 21 government agencies.[5] Executing agencies may be government line agencies and their attached bureaus, government nonbank financial institutions (NBFIs), government-owned and controlled corporations (GOCCs), and government financial institutions (GFIs). Some of these programs were implemented through GFIs. Government line agencies own the most number of DCPs, followed by GFIs. Together, they manage almost 80 percent of the programs, with line agencies overseeing 37 programs and GFIs handling 31 programs. The Department of Agriculture handles 12 programs while the Land Bank of the Philippines handles 21 programs.

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[4]*DCPs are credit programs implemented by the government and funded from sources external to the implementing institutions such as budgetary allocation, grants or loan proceeds from bilateral or multilateral donor organizations, and whose interest rates are subsidized.*

[5]*Gilberto M. Llanto, Ma. Piedad Geron and Ma. Christine Tang. 1999. Directed credit programs: issues and framework for reform. Manila: Department of Finance, National Credit Council.*

Data on initial fund allocation for 63 DCPs show that more than P40 billion, or 1.8 percent of GNP in 1996, were invested in the programs of the different agencies. DCPs in agriculture comprise almost P20 billion or 40 percent of total DCPs. The irony is that despite the huge amount of financial resources directed at the sector, many farm households still complain of lack of access to formal credit and thus, continue to depend on informal credit for their consumption and investment, including working capital, requirements. DCPs were implemented using subsidized interest rates resulting in very low cost recovery. Moreover, very low repayment rates plague these programs, creating a portfolio of nonperforming loans even as financial discipline was weakened by the distortions introduced in the financial markets by DCPs.

The persistence of the share of informal credit to total agricultural loans also indicates that credit absorption is a growth issue. This means that the rural economy has not grown to the extent that it will attract substantial financial resources from the banking system.

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The lessons are painful but clear. Among others, they include:

- the huge fiscal cost of unsustainable DCPs and weakened financial discipline among borrowers;
- overdependence on cheap funds and neglect of savings mobilization;
- weakened rural banking system that became dependent on subsidized funds;
- inefficient targeting leading to large leakages of subsidies to unintended beneficiaries, e.g., big farmers, agricultural technicians, and others;
- overall distortion in the financial market; and
- decades of neglect of the agriculture sector that thwart any attempt to provide formal financing to the sector.

The painful experience finally prompted the Philippine government to schedule a phase out of all DCPs by 2002. The legal basis for the termination of DCPs was the AFMA which provided a phase-out schedule for DCPs in the agriculture sector and Executive Order 138[6] which mandated a similar phase out of DCPs in the nonagriculture sector. The more important policy reform was the market orientation of credit policies and interest rates as provided for in both the AFMA and Executive Order 138.

Current rural finance policy framework

This section enumerates the government's intervention measures in the credit markets in the past decades which sought to direct credit to target sectors. It also describes the current rural finance policy framework brought about by the AFMA and Executive Order 138.

Credit allocation, loan targeting, credit subsidies and directed loans to certain sectors were the hallmark of the supply-led finance approach in the 1970s and 1980s. Funding was sourced from government budgetary appropriations and foreign loans. In the late 1990s, however, market-oriented financial and credit policy replaced the financial repression policies of the earlier decades.

[6] *Issued in August 1999.*

Policies in the 1970s

✲ ***Implementation of commodity-specific credit programs***. These programs were intended to meet the government's objective of attaining self-sufficiency in food requirements, particularly rice and corn.[7] The loans were channeled through the Philippine National Bank (PNB) and the Central Bank (CB) of the Philippines to rural banks which were given cheap funds for on-lending to small farmers at highly subsidized rates.

✲ ***Imposition of mandated credit quotas***. Presidential Decree 717 or the Agri-Agra Law, issued in 1975, mandated banks to set aside 25 percent of their loan portfolios for agricultural lending, 15 percent of which should be alloted to general agricultural lending and 10 percent to agrarian reform beneficiaries.

✲ ***Use of subsidized interest rates***. To lessen the cost of credit to the agriculture sector, the Central Bank (CB) opened a rediscounting window offering cheap funds for loans going to the agriculture sector. Rural banks were the chief beneficiaries of cheap funds from the CB.

Policies in the 1980s and early 1990s

✲ ***Deregulation of interest rates***. In 1981, the government initiated a set of financial policy reforms which deregulated the financial market. Interest rates were deregulated and credit subsidies were gradually removed. The CB rediscounting window, which served as the mechanism for preferential credit allocation, was also closed and the CB moved out of development financing. The use of market-based interest rates was adopted as a policy. In November 1994, the Bangko Sentral ng Pilipinas (BSP), which replaced the CB, issued a circular lifting the ceiling on lending rates for rediscounted papers covering agricultural production, cottage and small industries and financing of working capital.

✲ ***Promotion of savings mobilization as source of loan funds***. With the adoption of market-based interest rates, rural banks were expected to reduce their dependence on cheap government loan funds and mobilize savings as source of their loan funds to the rural sector.

✲ ***Consolidation of directed credit programs in the agriculture sector***. In 1986, the different funds used for commodity-specific agricultural lending were consolidated into the Comprehensive Agricultural Loan Fund (CALF) by virtue of Executive Order 113. Some 19 funds administered by the Ministry of Agriculture and Food (MAF) and the CB were consolidated into the CALF. Funds from the CALF were used to expand the guarantee operations of the Guarantee Fund for Small and Medium Enterprises (GFSME), the Quedan Guarantee Fund Board (QGFB), the Philippine Crop Insurance Corporation (PCIC) for agricultural production of small farmers and the Bagong Pagkain ng Bayan Program for rural-based projects of local government units. The guarantee program was intended to encourage private sector participation in agricultural lending by reducing the risks associated with agricultural lending.

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✲ ***Implementation of a Rural Bank Rehabilitation Program***. The financially repressive policies and programs implemented in the 1970s and the 1980s led to massive loan repayment problems and huge loan arrears among rural banks participating in the implementation of commodity-specific credit programs. In 1987, CB Circular 1143, later amended by Circular 1172, implemented a rehabilitation program for rural banks. The rural bank

[7] *Masagana 99 and Masaganang Maisan are examples of subsidized credit programs implemented in the 1970s with the key objective of increasing production of rice and corn.*

rehabilitation program under the direction of the Central Bank of the Philippines required rural banks to provide fresh infusion of equity as a ticket to the rehabilitation package which includes, among others, a debt for equity conversion scheme and a rescheduling of past due obligations with the CB, all intended to improve the balance sheets of the affected banks. In 1991, the Countryside Financial Institutions Enhancement Program (CFIEP) was established through CB Circular 1315. Under the program, counterpart capital infusion by LandBank was made available to match private capital infusion. Common stockholders were, however, exempted from the 20 percent ownership ceiling, and penalties and other charges on arrears covered by the program were waived. Finally, the 1992 Rural Bank Act provided for the implementation of a rehabilitation scheme for rural banks which allowed the conversion of a rural bank's arrears with the CB into government-preferred stocks in the bank. Owners were required to infuse an equal amount of capital over a period of 15 years.

Current policy framework

❇ ***Market-oriented financial and credit policies***. With the signing of the AFMA into law in December 1997, market-based interest rates in the implementation of government credit programs in the agriculture sector were adopted. AFMA also provided for the phase out of DCPs implemented by government nonfinancial agencies in the agriculture sector over a four-year period. The proceeds from the phased-out DCPs in the sector will be consolidated into the Agricultural Modernization Credit and Financing Program (AMCFP), which will then serve the credit demand of the agriculture sector using market-based interest rates. The program will be implemented through government and private financial institutions.

❇ ***Phase out of DCPs in other sectors***. To complement the provisions of the AFMA on the phase out of credit programs in the agriculture sector, the government also issued Executive Order 138 to effectively phase out all directed credit programs in other sectors and to terminate the participation of nonfinancial government agencies in the implementation of credit programs.[8] The EO also mandates the adoption of market-based financial and credit policies and the use of government financial institutions as the vehicle for the delivery of wholesale credit to private financial institutions that will take care of on-lending at the retail level. The underlying theme of AFMA and EO 138 is the use of the market mechanisms in the allocation of financial resources and the reliance on domestic savings mobilization to fund credit programs.

❇ ***Advent of microenterprise finance***. The failure of the formal banking system, especially traditional commercial banking and the costly DCPs to provide financing to the rural sector, led to the evolution of various microfinancing techniques among private microfinance institutions. Credit-granting nongovernmental organizations, credit cooperatives and, to some extent, a few rural banks have utilized microfinance as a sustainable mechanism to provide basic financial services to small-scale borrowers. This new phenomenon has already taken place in

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[8]The National Credit Council (NCC) recommended the issuance of the EO to complement the reforms in the rural credit market espoused in the AFMA. It believes that the phase out of DCPs should be implemented in all sectors to minimize risks of policy reversals as what happened in the mid-80s.

several urban areas but still has to prove its usefulness for rural-based clients involved in farm and nonfarm enterprises. The important thing to stress is the success of private microfinance operation to achieve high levels of sustainability, given the appropriate financial and credit policies, and deregulated interest rates, compared to the rather poor performance of government microcredit programs, including DCPs, and their failure to attain self-sustaining operations.

Policy and design issues in Philippine rural finance

Given the sad experience of the supply-led credit policy and subsidized DCPs in the past, it is important that the same mistakes be avoided and that lessons be learned from such mistakes. The important lesson here for policy and design initiatives is the reality of policy reversals and the ever-present threat of such reversal given populist sentiments and lack of appreciation for the perverse effects of financially repressive policies. The passage of AFMA and the issuance of Executive Order 138, meanwhile, indicate the triumph of the financial markets approach to rural finance with clear emphasis on market orientation, especially the interest rate policy.

The failure of past interventions has led to attempts to introduce a market-oriented financial and credit policy framework. An initial response by private agents is the emergence of a new class of credit intermediaries—the microfinance institutions (MFIs) that provide loans without collateral on a moment's notice and at market-rate interests to a growing number of small-scale clientele, mostly nonfarm enterprises and microenterprises. The MFIs have proven to be sustainable and capable of reaching a large number of assetless, small borrowers who have viable projects and the determination to repay their loans on time.

Voluntary savings mobilization is a key ingredient of this approach. This has equipped private microfinance institutions with a large liquidity base for funding the asset side of the balance sheet. An example is the Center for Agriculture and Rural Development (CARD) Rural Bank

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in San Pablo City which currently has more than 40,000 small borrowers, reports a portfolio at risk of less than 0.05 percent and a large number of small savers who save on a regular and sustained basis.

The new paradigm, therefore, reflects the economy's commitment to financial market liberalization and the expectation that small-scale clients stand a better chance of accessing formal financial services under a financial market framework. In another sense, pushing the financial frontier *à la* von Pischke has been made possible by a number of innovative products, institutions and the open attitude adopted by the Philippine authorities with respect to the new paradigm. This can only happen in a flexible, market-oriented policy setting which is quite different from the traditional government approach to agricultural and rural credit programs characterized as (1) rigidly designed and commodity-oriented; (2) unsustainable though providing very cheap credit; (3) overly dependent on budgetary appropriation and external funding; and (4) dismissive of savings mobilization on the mistaken belief that rural households do not save and incomes are so marginal that such households cannot save.

It is important, however, to point out a threat to the growth and sustainability of rural financial markets—government's inconsistent interest rate policy. While both the BSP and other government agencies like the National Economic and Development Authority (NEDA) and the Department of Finance have supported financial reforms, especially the adoption of market-based interest rates, this does not seem to be implemented at the operations level by government financial institutions. Interest rate subsidies continue to be provided in some credit programs implemented by the government.

It is also necessary to review provisions in certain laws that put caps on lending rates such as the preferential loans to small landowners, farmers and farmers' organizations under the Comprehensive Agrarian Reform Law (RA 6657, 1988) and the mandated lending rates to small farmers not exceeding 75 percent of prevailing market rates, inclusive of service charges under the Magna Carta for Small Farmers (RA 7607, 1992). The government has to resolve the policy inconsistency between the liberal, market orientation of AFMA and Executive Order 138, on the one hand, and the provision of subsidized credit to target sectors under the Magna Carta for Small Farmers and the CARL, on the other.

A crucial dimension taught by successful microfinance programs is the advantage of locally designed and monitored credit programs over those that are centrally designed and directed. Information asymmetries tend to break down in localized settings. The application of collateral substitutes such as peer pressure, third party guarantees, group dynamics that strengthen loan repayment discipline to noncollateralized lending varies from area to area. Credit risks and other risks are not necessarily the same and centrally directed credit programs tend to miss out on the nuances of risk profiles and the applicable risk mitigation measures that need to be employed to ensure the integrity of the credit transaction.

Finally, it is also crucial to emphasize the necessary macroeconomic underpinnings of sustainable rural finance. A stable macroeconomic environment characterized by low inflation expectations is a necessary condition for growth of the financial markets. It encourages the expansion of formal financial institutions deeper into the countryside, thereby providing a stronger competitive pressure vis-à-vis informal lenders.[9]

At the same time, it is necessary to remove barriers to entry to the financial markets in order to introduce greater competition in the financial marketplace. Competitive financial markets provide more alternative loan sources and better pricing to borrowers and offer better returns to savers. They lead to financial deepening and the improvement of the provision of financial services and encourage financial innovations—all for the benefit of the rural finance clientele.

[9] *Ponciano S. Intal Jr. and Gilberto M. Llanto. 1998. Financial reform and development in the Philippines, 1980-1997: imperatives, performance and challenges.* Journal of Philippine Development *45 Vol. XXV (1).*

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